

### **A. Ratepayer Impacts.**

The comments confirm that the several billions of dollars of phantom investment central office equipment in the RBOCs' CPR have substantially inflated the RBOCs' access charges and other rates. The RBOCs comments do little more than rehash the arguments of Bell Atlantic that AT&T and others have already shown to be baseless. *See* AT&T Comments at 29-36; MCI WorldCom Comments at 34-40.

For example, many of the RBOCs continue to advance the baseless contention that errors in the CPR have no effect on the USOA accounts. *E.g.*, Bell Atlantic Comments at 8; SBC Comments at 52; U S WEST Comments at 26. As AT&T and others showed, the Commission's rules require the RBOCs to reconcile the USOA accounts and the CPRs on an annual basis. AT&T Comments at 30-31; 47 C.F.R. § 32.2000(e)(2)(iii). Indeed, the CPRs are the *only* source data for recording retirements of equipment in the USOA accounts. Bell Atlantic Response at 14. Therefore, if the RBOCs have improperly failed to remove from the CPRs equipment that has been retired or that was never placed in service at all, then there is necessarily a corresponding failure to remove that equipment from the USOA accounts, and those accounts are thus overstated.<sup>35</sup>

With respect to the impact of the overstatements on the RBOCs' revenue requirements, the RBOCs simply restate arguments that have already been refuted by the Snavely King Report. *See* MCI WorldCom Comments, Att. 2 ("Snavely King Report"). As the Snavely King Report

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<sup>35</sup> *See, e.g.*, Chairman's Letter, Attachment at 4-5 ("a proper reconciliation requires an investigation of differences so that corrections can be made either to the CPRs or to the books of account as appropriate. Accordingly, whatever is misstated in one is misstated in the other, and, absent a showing to the contrary by the carriers, the auditors logically conclude that the overstatements found in the CPR are also present in the regulated books of account").

demonstrates, the overstatements in the RBOCs' USOA accounts do result in overstatements of the RBOCs' revenue requirements. The magnitude and nature of the effect on the revenue requirements depends on whether the plant was ever in service at all, or whether the LEC merely improperly failed to record the retirement of plant that was once in service (a "delayed" retirement)—and when the actual retirement occurred. If the plant was never put in service at all, the result is an overstatement of both the rate base and depreciation expense. Snavely King Report at 4-6. If the error is a "delayed retirement," the result is still an overstatement of depreciation expense. *Id.* at 6-9.

None of the RBOCs offers any evidence that any of the equipment that they cannot now locate was ever in service. The Snavely King Report concluded that the notion that all of the missing equipment are delayed retirements is highly implausible, and the RBOCs have done nothing to rebut that conclusion. Snavely King Report at 3-4. As shown before, at a minimum the missing equipment from more recent vintages were almost certainly never in service, because retiring equipment so quickly after its entry into service would be highly unusual. *Id.* at 9-10. Moreover, the rate impact of missing equipment that was never in service is especially severe, since it results in an overstatement of both the rate base and depreciation expense. Snavely King Report at 4-5.

In addition, contrary to the insistence of the RBOCs, delayed retirements cause an overstatement of depreciation expense. Snavely King Report at 6-9; *see* Ameritech Comments at 24; BellSouth Comments at 44-45; Notice of Inquiry, *Comments of GTE* at 9, CC Docket No. 99-117, ASD File No. 99-22 (Sept. 23, 1999) ("GTE Comments"); SBC Comments at 52-53; U S WEST Comments at 27. On this point, the RBOCs do nothing more than repeat arguments that the Snavely King Report has refuted in detail. As explained before, if the retirement had

been recorded properly, the remaining life depreciation rate would not have changed (because the decrease in the reserve ratio would have been canceled out by the increase in the remaining life). Snavelly King Report at 6-9. Therefore, a delayed retirement results in the same depreciation rate being applied to an *overstated* gross plant. Delayed retirements therefore result in an overstated depreciation expense, and an overstated revenue requirement.

Similarly, the Snavelly King Report refutes the RBOCs' arguments, repeated again in their comments, that the overstatement of depreciation expense would not affect the RBOCs' revenue requirement under the Commission's pooled depreciation methodology. Snavelly King at 7-9; *see* Ameritech Comments at 24-25; Bell Atlantic Comments at 8; BellSouth Comments at 45; SBC Comments at 52. As Bell Atlantic's expert previously conceded, there is no *fixed* relationship between a failure to retire plant and the revenue requirement; it may increase or decrease depending on the "direction of movement in the composite remaining life of a plant category." Bell Atlantic Response, Exh. 5, ¶ 6 ("White Aff."). Specifically, if the delayed retirements are concentrated in the older vintages, the result would be an overstated gross plant and an understated remaining life, and thus an overstated revenue requirement. Snavelly King Report at 8-9. The delayed retirements *are* likely to be concentrated in the older vintages, because it is unusual to retire equipment within a few years of deployment. *Id.* at 9-11.

Because overstatements in the RBOCs' USOA accounts indisputably inflate their revenue requirements, the RBOCs' argument that the phantom equipment has not resulted in excessive rates collapses. Because the price caps were initially set at the RBOCs' rates as of July 1,

1990,<sup>36</sup> any missing equipment that was missing on that date would have caused the initial price caps to be overstated. Moreover, as explained before, to the extent that the initial price caps were overstated, the price caps have been at excessive levels *every year since 1990*, and indeed, those overstatements would persist to this day. As AT&T and others showed, there is good reason to believe that much of the equipment was in fact missing as of 1990, *see* AT&T Comments at 33-34; MCI WorldCom Comments at 39-40, and the RBOCs have offered no evidence to cast doubt on that conclusion.

The RBOCs' only answer is that Commission statements in the original price cap orders somehow "estop" the Commission from revisiting the initial price cap levels. *See, e.g.,* SBC Comments at 54-55. To the contrary, the Commission merely decided to adopt the price cap system without a full rate investigation; the Commission never suggested that it would refrain from taking appropriate corrective action if excessive costs were nonetheless shown (as the audits now have). *See Policy and Rules Concerning Rates for Dominant Carriers*, 4 FCC Rcd. 2873, 3245-47 (1989).

#### **B. Accounting Corrections for Missing HWC OE.**

The RBOCs have offered no evidence to rebut the reasonable conclusion that these rate impacts are likely quite substantial. The Commission should therefore continue its investigation so that it can quantify the effects on the RBOCs' rates more precisely, and it should take

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<sup>36</sup>*Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd. 6786, 6814 (1990). The rates set as of July 1, 1990, were then adjusted downward to reflect a rate of return equal to 11.25 percent.

corrective action. Because substantial excessive costs are almost certainly embedded in the RBOCs' price cap indices, the Commission should ultimately order a prospective downward adjustment for all price cap RBOCs that are not signatories to the CALLS Plan to remove the phantom costs of missing plant.<sup>37</sup> The Commission has ample authority to order such adjustments. *See, e.g., Bell Atlantic Tel. Cos. v. FCC*, 79 F.3d 1195, 1204 (D.C. Cir. 1996); *The Bell Atl. Tel. Operating Cos.*, Order to Show Cause, 10 FCC Rcd 5099, 5102 (1995); *The Bell Atl. Tel. Operating Cos.*, Consent Decree Order, 11 FCC Rcd 14839, 14840 (1996); *The GTE Tel. Operating Cos.*, Consent Decree Order, 9 FCC Rcd 2594, 2595 (1994); *see also* MCI WorldCom Comments at 41.<sup>38</sup>

The CPR errors would also have resulted in excessive rates in prior years under the sharing rules. Here again, the RBOCs' arguments to contrary rest solely on their contentions – refuted in the Snavely King Report – that the CPR errors had no impact on their revenue

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<sup>37</sup> *See Access Charge Reform*, CC Docket Nos. 96-262 et al., Notice of Proposed Rulemaking (rel. September 15, 1999) (seeking comment on the proposal of the Coalition for Affordable Local and Long Distance Services). For the signers of the CALLS Plan, AT&T has agreed that the price cap changes proposed in the plan are “just, reasonable and fair”—and prospective changes in interstate access rates of the signatory RBOCs based on the results of the Continuing Property Records audits shall be “unnecessary”—if the FCC adopts in their entirety the access rates proposed in the CALLS plan. CALLS Proposal, ¶ 4.2.

<sup>38</sup> Nor is there any merit to the suggestion that Section 205 of the Act would bar such a proceeding. *See, e.g., MTS and WATS Market Structure*, Third Report and Order, 93 F.C.C.2d 241, 256 n.18 (1983) (Notice and comment rulemaking sufficient to satisfy the 205(a) requirement that prescription power may be exercised only after a full opportunity for hearing); *American Tel. & Tel. Co. v. FCC*, 572 F.2d 17, 21-23 (2d Cir.), *cert. denied*, 439 U.S. 875 (1978) (same); *International Settlement Rates*, IB Docket No. 96-261, Report and Order on Reconsideration and Order Lifting Stay, FCC 99-124, para. 17 (June 11, 1999) (notice and comment provisions of section 553 of the APA satisfy a general hearing requirement such as that contained in section 205; Commission did not need to issue an order of investigation on its own motion, because NPRM satisfied the requirement and gave all interested parties ample opportunity to present their views).

requirements. *See, e.g.,* Ameritech Comments at 25; BellSouth Comments at 47-48; SBC Comments at 56. In any given year, to the extent that equipment missing at that time was never in service, the result would have been an overstatement of the rate base and/or depreciation expense, and thus an understatement of the price cap RBOCs' interstate rate of return. Under the sharing rules in effect from 1991 through 1997, if the RBOCs' interstate rates of return were understated, that would have translated directly into understated cap reductions the following year. Moreover, as AT&T showed, the impact on the price cap RBOCs' sharing amounts was almost certainly substantial, because most of the missing equipment from the more recent vintages -- *i.e.*, the period governed by the price cap regime -- was probably never placed in service at all (rather than being a delayed retirement), and therefore would have resulted in an overstated rate base. Because most of the price cap RBOCs' earnings were in the sharing zones (or qualified for a lower formula adjustment) for most of the years from 1991 to 1995 (and some price cap RBOCs, such as U S WEST, continued under sharing until 1997), these overstatements in the RBOCs' rates of return would have had a dollar-for-dollar impact on their sharing obligations.

The claims of some LECs that overstatements in the CPR would lead to an overstatement of the X-Factor under the Commission's total factor productivity ("TFP") methodology are baseless. Ameritech Comments at 25; BellSouth Comments at 49-50. To be sure, the RBOCs' overstated CPR could have caused the capital stock in the FCC's TFP study to increase over time, so that growth in inputs would have been overstated. In the absence of any other effect, the effect would have tended to understate TFP growth, which is defined as growth in output minus growth in input. But that is only half of the story. In the FCC's model, any distortion in measuring the capital stock creates an offsetting distortion in measuring the "capital rental price," which is the capital component of the overall input price index. The capital rental price is

equal to "property income" (total revenue minus operating expenses) divided by the computed capital stock. If the capital stock is overstated, the capital rental price will be understated by an offsetting amount. The understatement in TFP growth is thus accompanied by a corresponding understatement of input price growth. The understatement in TFP growth has the effect of reducing the estimated X-Factor, but the understatement of input price growth has the offsetting effect of increasing the estimated X-Factor. The two effects exactly cancel out, leaving no net effect on the X-Factor.

### **C. Accounting Corrections to Resolve "Undetailed Investment."**

The initial comments of other parties confirm that the RBOCs should be required to show cause why the "undetailed investment" in their property accounts should be removed immediately. Except for particular items of equipment that the RBOCs can show are still used and useful, and thus for which they can generate a valid CPR, all such items should be retired forthwith and the property records should be adjusted downwards. AT&T Comments at 39-40.<sup>39</sup>

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<sup>39</sup> *Accord, Audit of the Continuing Property Records of the Pacific Bell and Nevada Bell Telephone Companies As of June 30, 1997* ¶ 38 (FCC Dec. 22, 1998) ("Pac-Bell Rpt.") ("the amounts associated with . . . Undetailed Investment . . . should be written off."); *Audit of the Continuing Property Records of US WEST Telephone Companies As of June 30, 1997* ¶ 38 (FCC Dec. 22, 1998) ("US WEST Rpt.") (same); *Audit of the Continuing Property Records of Ameritech Corporation As of June 30, 1997* ¶ 37 (FCC Dec. 22, 1998) ("Ameritech Rpt.") (same); *Audit of the Continuing Property Records of Southwestern Bell Telephone Company As of June 30, 1997*, ¶ 38 (FCC Dec. 22, 1998) ("SBC Rpt.") (same); *Audit of the Continuing Property Records of BellSouth Telecommunications, Inc. As of June 30, 1997*, ¶ 37 (FCC Dec. 22, 1998) ("BellSouth Rpt.") (same); BA-North Rpt. ¶ 39 (same); MCI Comments at 40 ("Commission should require the RBOCs to make downward adjustments to . . . remove the effects of plant overstatement."); New York Comments at 8 ("Federal and State regulators have an obligation to prevent such inflation and inaccuracies by performing audits as appropriate and requiring remedial action to correct for significant inaccuracies.").

#### **D. Future Audit Requirements.**

The large number of sampled items that the RBOCs and their outside auditors were unable to find during and after the audit process brings into question not only the accuracy of the RBOCs' property accounts, but also the competence and integrity of the RBOCs' accounting controls. Restoring public confidence in these critical regulatory safeguards dictates thorough scrutiny of the records by expert and disinterested parties. *See* AT&T Comments at 40. The need for comprehensive outside audits is entirely of the RBOCs' own making, through their chronic failure to maintain their property records in compliance with the Commission's long-standing requirements. *See See, e.g., Audit of the Continuing Property Records of BellSouth Telecommunications, Inc. As of June 30, 1997*, ¶ 32 (FCC Dec. 22, 1998) ("It is unlikely that such a large number of errors . . . occurred over a short span of years. It is much more likely that [the RBOC] has been recording a substantial percentage of its entries inaccurately for many years."); Ameritech Rpt. ¶ 33 (same); US WEST Rpt. ¶ 33 (same); SBC Rpt. ¶ 33 (same); Bell Atlantic-North Rpt. ¶ 33 (same); Pacific Bell Rpt. ¶ 33 (same).

#### **V. OTHER ISSUES.**

Many states have adopted regulatory procedures very similar to section 32.0000 of the Commission's rules. *See, e.g.,* New York Comments at 1 ("state utility regulatory agencies rely on the FCC's [USOA] to review the RBOCs' interstate plant and investments. . . . [NYPSC's] determinations of jurisdictional separations, intrastate price cap levels, and other significant findings rely on the capital investment stated in NYNEX/Bell Atlantic North's [CPR]"); Notice of Inquiry, *Comments of the Illinois Commerce Commission* at 2, CC Docket No. 99-117, ASD File No. 99-22 ("In Illinois, 83 Illinois Administrative Code Part 710 adopts the [USOA] for telecommunications carriers codified in 47 [CFR] Part 32, with minor modifications."). Failure

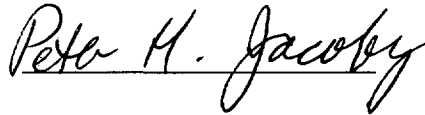


by the Commission to act is likely to force state regulatory agencies to institute costly separate investigations of the RBOCs. This point is illustrated by promises of Illinois and New York to look into this problem. Thus, the interest of a cost efficient and consistent resolution to the problem, further confirms the need for immediate Commission action.

## CONCLUSION

For the foregoing reasons, the Commission should affirm the findings of the Staff's RBOC audit reports and order appropriate corrective actions, as described herein and in AT&T's initial comments, to remedy the RBOCs' massive overstatement of HWCOE in service.

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